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No. 67

In the Supreme Court of the United States

OCTOBER TERM, 1929

ROBERT H. LUCAS, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

AMERICAN CODE COMPANY, INCORPORATED

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR PETITIONER

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OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 7–9) is reported in 10 B. T. A. 476. That of the United States Circuit Court of Appeals for the Second Circuit (R. 14–18) is reported in 30 F. (2d) 222.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on January 21, 1929. (R. 19.) Petition for writ of certiorari was filed on April 19, 1929, and granted on May 20, 1929. (R. 21.) The

jurisdiction of this Court rests upon Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

In 1919 respondent broke a contract with its employee who instituted suit for damages in the same year. Respondent asserted a previous breach of the contract by the employee and defended the suit. The case was decided against the taxpayer in the lower court in 1922 and this decision was finally affirmed in 1923. Respondent kept its books and made its income tax returns on the accrual basis and set up a reserve at the end of 1919 on account of its alleged liability for the breach of the contract. Upon these facts the question is whether the amount of the judgment rendered against it in a later year is a loss sustained by the respondent during 1919 within the meaning of Section 234 (a) of the Revenue Act of 1918.

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1918, c. 18, 40 Stat. 1057, 1064, 1077, 1078:

> SEC. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:
>
> (1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *;
>
> * * * * *

(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise;

* * * * *

SEC. 212. (b) The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. * * *

SEC. 232. That in the case of a corporation subject to the tax imposed by section 230 the term "net income" means the gross income as defined in section 233 less the deductions allowed by section 234, and the net income shall be computed on the same basis as is provided in subdivision (b) of section 212 or in section 226.

Regulations 45 (1920 ed.) provide:

ART. 111. *When charges deductible.*—Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. See articles 21–24

and 52. The expenses, liabilities or deficit of one year can not be used to reduce the income of a subsequent year. A person making returns on an accrual basis has the right to deduct all authorized allowances, whether paid in cash or set up as a liability, and it follows that if he does not within any year pay or accrue certain of his expenses, interest, taxes or other charges, and makes no deduction therefor, he can not deduct from the income of the next or any subsequent year any amounts then paid in liquidation of the previous year's liabilities. A loss from theft or embezzlement occurring in one year and discovered in another is deductible only for the year of its occurrence. Any amount paid pursuant to a judgment or otherwise on account of damages for personal injuries, patent infringement or otherwise, is deductible from gross income when the claim is put in judgment or paid, less any amount of such damages as may have been compensated for by insurance or otherwise. If subsequently to its occurrence, however, a taxpayer first ascertains the amount of a loss sustained during a prior taxable year which has not been deducted from gross income, he may render an amended return for such preceding taxable year, including such amount of loss in the deductions from gross income, and may file a claim for refund of the excess tax paid by reason of the failure to deduct such loss in the original return. See section 252 of the statute and articles 1031–1038.

STATEMENT OF FACTS

The findings of fact made by the Board of Tax Appeals are as follows (R. 8–9):

The taxpayer is a New York corporation, organized in the year 1914 in the Borough of Manhattan of the city of New York.

On January 3, 1919, the taxpayer entered into a contract of employment with one Cosmo Farquhar for a term to begin on January 3, 1919, and to end on February 1, 1937, the compensation of the employee to be a commission based upon the sales made in the petitioner's business.

On May 1, 1919, the taxpayer discharged the said Cosmo Farquhar from its employ.

In July, 1919, Farquhar began action against the taxpayer in the Supreme Court of New York County to recover commissions due him for April, 1919, alleged to be $100, and for breach of the contract of employment, claiming damages for such breach in the amount of $100,000. The taxpayer defended such action on the ground that Farquhar had previously broken his contract of employment and that his discharge was justified by reason of his failure to perform his duties. This action was reached for trial in January, 1922, and resulted in a verdict by the jury against the taxpayer and an award of damages in favor of Farquhar for breach of contract in the sum of $21,019.19.

The taxpayer appealed to the Appellate Division of the Supreme Court, State of New York, which

court, on June 2, 1922, affirmed the judgment. Taxpayer then appealed to the Court of Appeals of the State of New York, in which court the judgment was again affirmed on the 16th day of January, 1923.

The taxpayer paid the amount of said judgment in January, 1923.

The taxpayer kept its books and made its income tax returns on the accrual basis.

The taxpayer, at the close of the year 1919, set up on its books as a reserve for the breach of the contract of employment the amount of $14,764.79, such amount having been computed at the rates of commission and on the basis specified in the said contract. At the close of the year 1920 this reserve was increased on the taxpayer's books by $32,994.09 to conform to the amount of its liability computed on the same basis, and at the close of the year 1921, judgment having been rendered early in January, 1922, before the books had been closed for 1921, the reserves so set up on its books, amounting to $47,458.88, were adjusted to the liability as fixed by the judgment against the taxpayer in the sum of $21,019.19.

On October 28, 1919, the taxpayer wrote the Commissioner that its employee was suing to recover commissions due under the contract and made a written request of the Commissioner of Internal Revenue for permission to deduct from taxpayer's income-tax return for 1919 the accumulated

commissions which would be due on December 31, 1919, under the contract, which request was denied on November 11, 1919.

The taxpayer, in compliance with said ruling by the Commissioner, did not deduct in its 1919 income-tax return the amount set up as a reserve for 1919 commissions, but on January 21, 1925, its 1919 return being then in process of audit by the Income Tax Bureau, the taxpayer filed a claim for refund with the Commissioner of Internal Revenue, in which it claimed the right to deduct from its income for the year 1919 the amount of its liability for breach of the said contract of employment, the sum of $21,019.19, and asserted that by reason of such deduction it was entitled to a refund of income tax paid for 1919 in the sum of $9,364.85.

The Commissioner, in a notice dated September 17, 1925, rejected such claim for refund and asserted a deficiency in tax against the taxpayer for 1919 for $122.91.

The taxpayer thereupon appealed to the United States Board of Tax Appeals, and the Board, upon hearing, affirmed the determination of the Commissioner. (R. 10.) Taxpayer then brought the case by petition for review to the Circuit Court of Appeals for the Second Circuit, and that court, after hearing, reversed the decision of the Board. (R. 19.)

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SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

I. In reversing the order of redetermination of the Board of Tax Appeals.

II. In holding that the item in question was properly deductible from gross income for the year 1919, within the provisions of Section 234 (a) of the Revenue Act of 1918.

SUMMARY OF ARGUMENT

Where a private cause of action against a taxpayer arose in one tax year but liability thereon was denied, and not finally determined until several years later, following an adverse judgment, there is no accrual of the loss occasioned by that judgment in the year in which the cause of action arose, even though taxpayer set up on its books a reserve to meet the judgment, if suffered. A loss in such a case grows out of the original facts which gave rise to the action, but only becomes a loss upon the determination of liability and the assessment of damages by court and jury. It is thus plain that at the time the cause of action arose all the events had not occurred which either determined the liability or even approximately fixed the amount of that liability. Until these elements are ascertained, it must follow, under the rule laid down by this Court in *United States* v. *Anderson*, 269 U. S. 422, that there can be no accrual. To hold otherwise would be to ignore the effect of the rule laid down in the *Anderson case* and generally fol-

lowed by the courts and the Board of Tax Appeals and to unsettle a practice consistently followed by the Department charged with the enforcement of the tax laws.

ARGUMENT

A LOSS OR EXPENSE INCURRED BY A JUDGMENT FOR THE BREACH OF A CONTRACT IS ONLY DEDUCTIBLE IN THE YEAR IN WHICH THE LIABILITY AND THE DAMAGES BECOME DEFINITELY FIXED BY FINAL ADJUDICATION, EVEN THOUGH A RESERVE WAS SET UP IN THE YEAR IN WHICH THE BREACH OCCURRED

The decision of this Court in *United States* v. *Anderson,* 269 U. S. 422, established the principle that a taxpayer keeping his books on the accrual basis could deduct an expense only in the year in which all the events occurred which determined the liability upon which the expense was based.

In the instant case the Circuit Court of Appeals has allowed the deduction to be taken in 1919, although neither the liability nor its amount was determined in that year. The respondent defended the suit which was commenced in that year, alleging a previous breach by the employee, and its liability was not finally adjudicated until 1923. The decision of the Circuit Court of Appeals is largely predicated upon the fact that the respondent set up a reserve in the year in which the contract was broken and upon the principle of contract law that damages are suffered at the time a contract is broken.

In the *Anderson case, supra,* this Court held that taxes for the year 1916 became fixed and determinable in that year, though not due until 1917, and sustained the decision of the Commissioner that a deduction for such taxes should be taken in 1916 rather than in 1917. It was there said (p. 441):

> In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and becomes due; but it is also true that in advance of the assessment of a tax, all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it. In this respect, for purposes of accounting and of ascertaining true income for a given accounting period, the munitions tax here in question did not stand on any different footing than other accrued expenses appearing on appellee's books. In the economic and bookkeeping sense with which the statute and Treasury decision were concerned, the taxes had accrued.

Applying the above statement to the facts of the instant case, it is apparent that, while the loss suffered by respondent arose out of its action in discharging its employee in 1919, the determination that there would be a loss and the fixation of the amount of that loss were dependent upon the action of the courts, which did not occur until a subsequent year. It is manifest, therefore, that in 1919 all the events had not occurred which fixed even the approximate amount of the judgment and determined the liability of the taxpayer to pay it. In

such circumstances we submit that there could be no accrual in 1919.

In *Lewellyn* v. *Electric Reduction Co.*, 275 U. S. 243, the taxpayer contracted with third parties for the purchase of certain ores and, in compliance with the terms of that contract, accepted and paid a draft, believing that certain of the ores had been shipped to it. In fact, they had not been, and in large part never were. It thereafter instituted action against the other parties to the contract to recover the amount of the draft paid by it. Those proceedings were not terminated for several years, and it was only in the latter of these years that it was finally determined that the sum in question was irrevocably lost. Taxpayer thereupon filed an amended return for the year in which the contract had been made, asserting that it should be allowed to deduct the loss suffered in that earlier year. The Commissioner determined that the loss was only deductible in the later year, and this Court sustained the Commissioner, saying (p. 246):

> But we do not think that a loss resulting from a buyer's prepayment to a seller who proves to be irresponsible is necessarily sustained, in the statutory meaning, as soon as the money is paid. The statute was intended to apply not only to losses resulting from the physical destruction of articles of value but to those occurring in the operations of trade and business, where the business man has ventured on a course of action

> in the reasonable expectation that the promised conduct of another will come to pass. Not only the future success of the business but its present solvency depends on the probable accuracy of his prophecy. Only when events prove the prophecy to have been false can it be said that he has suffered. His case is not like that of a man who fails to learn of the theft of his bonds or the burning of his house until a year after the occurrence; but rather resembles the position of a merchant who buys in one year, for sale in the next, merchandise which shifting fashion renders unsaleable in the latter. It may well be that he whose house has been burned has sustained a loss whether he knows it or not and may recover a tax paid in ignorance of that material fact. But we can not say that the merchant whose action has been based not merely on ignorance of a fact but on faith in a prophecy—even though the prophecy is made without full knowledge of the facts—can claim to have sustained a loss before the future fails to justify his hopes.

It is contended that the facts of that case are fairly analogous to those here involved, and that the conclusion reached therein should have been followed in this case. The controlling factor in each case was the determination that there was an actual loss, and a fixation of its amount. In the *Electric Reduction Co. case* the loss was occasioned by the breach of a contract by another. In the year in which the breach occurred, it was impossible to

ascertain whether or not a loss would result. In the instant case the loss was occasioned by the breach of a contract by the taxpayer. As respondent denied liability, it was equally impossible in the year of the breach to determine that there would be a loss.

In the *Electric Reduction Co. case* it was further said (p. 247):

> Here the only fact relied upon to show a loss is the outcome of the litigations two years after respondent's payment to Jouravleff. There is nothing in the findings from which we could conclude that the respondent in 1918 had ceased to regard his rights under the contract as having value or that there was then reasonable ground to suppose that efforts to enforce them would be fruitless. On the findings respondent is not entitled to recover.

Since the fact relied upon in the instant case to show a loss is the outcome of litigation in a subsequent year, the analogy between the two cases is apparent. The deduction sought in the instant case, like that in the *Electric Reduction Co. case,* is unlike that which would be sought in the case of a burned house or a stolen bond. There the loss, even though unknown to the victim, is determined by the fire or the theft without the intervention of any other factor. Here the loss is not alone determined from the facts of the original transaction but requires, in addition thereto, the subsequent

action of court and jury, which may determine that there is no loss, that the loss is exceedingly small, or that it is as large as the total amount sued for.

The Circuit Court of Appeals distinguished the *Electric Reduction Co. case* on the ground that: "Whether the taxpayer kept his books on a cash or an accrual basis does not appear, but he did not charge off the asset in the year in question." (R. 18.) It is submitted that neither the fact that the taxpayer was not shown to be on an accrual basis, nor that he had not yet abandoned hope of recovery, was the controlling consideration in the *Electric Reduction Co. case.* Rather it is believed that the determinative factor was that in the taxable year 1919 the events which proved the claim to be uncollectible had not yet happened.

With respect to deductible losses, the only difference between a taxpayer on the accrual basis and a taxpayer on the cash basis is that the former is permitted to take a loss when the liability becomes fixed while the latter must await the actual payment. The same certainty is required in both cases and in neither can a deduction be taken for a loss which is indefinite or contingent.

The same principle was applied by the Court of Claims in the case of *Malleable Iron Range Co.* v. *United States,* 62 Ct. Cls. 425, which involved the deductibility of a loss resulting from a judgment, the taxpayer being on the accrual basis. In that case a judgment was rendered against the taxpayer

in the year 1918. The taxpayer appealed from the judgment, which was affirmed in 1920 for an increased amount. The taxpayer set up on its books in the year 1918, as an accrued liability, the amount of the judgment, together with interest to the end of the year. In order to provide against an increase in the judgment the taxpayer accrued an additional sum on its books for 1919. In making its returns for 1918 and 1919, the taxpayer attempted to deduct the amounts which had been set up on its books. Those deductions were not allowed by the Commissioner of Internal Revenue, since the liability of the taxpayer to pay the judgment was not determined until 1920. Applying the law and the regulations to these facts, the Court of Claims held that the deductions were properly disallowed, and said (pp. 432, 433):

> It would seem plain from the foregoing that when there is a question of whether or not there is any liability, no amount can accrue until it is determined that a liability exists. When the amount in question is in litigation it cannot be determined until the litigation is ended. * * *
> Until all the events occurred which fixed the amount to be deducted, and determined the liability of the taxpayer to pay it, there was no method by which the Commissioner of Internal Revenue could assess the amount of the tax.

Petition for certiorari in that case was not opposed by the United States and was granted by this Court (273 U. S. 688). Thereafter upon motion the case was remanded to the Court of Claims for additional findings in respect to the outlay in bonds or money required to be deposited by the taxpayer in securing a stay of the execution of the judgment (273 U. S. 674).

It appeared from the findings, as amended in compliance with the order of this Court, that at the time of the judgment against it in the District Court, the taxpayer had deposited with a trust company bonds in an amount greater than the judgment. (65 Ct. Cls. 441.) With these additional findings the Court of Claims said that the question was whether, in the circumstances of this case, this *outlay* was a proper accrual under the statute. The Court of Claims held that, by its action in putting the bonds in trust, the taxpayer destroyed their availability as an asset in the business as completely as if their value in cash had been withdrawn from its treasury and that its financial position was as much affected by the deposit of the bonds as it would have been by the deposit of the equivalent cash. It was accordingly held that the taxpayer was entitled to the deduction claimed for 1918. However, the deduction claimed for 1919 was not allowed, for the reason that the taxpayer had not parted with any further sums of money in that year and no facts had occurred to justify an

accrual, which was merely a precautionary measure based upon no known fact, but upon a possibility, a speculation.

The second decision of the Court of Claims clearly distinguishes between an accrual based upon mere possibility, which we submit is the situation in the case at bar, and an actual outlay of funds. It is evident that the deduction for 1918 was allowed in that case, not because it had been accrued on the books, but because there had been an actual outlay. With respect to both of these deductions the decision gives effect to the fundamental rule underlying the decisions in *United States* v. *Anderson, supra,* and *American National Co.* v. *United States,* 274 U. S. 99, that the computation must be made in such a manner as clearly reflects the taxpayer's income.

A conclusion similar to that of the Court of Claims in the second *Malleable Iron Range decision* was reached by the Circuit Court of Appeals for the Second Circuit in *Becker Bros.* v. *United States,* 7 F. (2d) 3. In that case the judgment was rendered against plaintiff in 1914 and plaintiff deposited in escrow a sum of money sufficient to meet this judgment. In 1916, following appeal and affirmance, the judgment was paid. The court, resting its decision largely upon the taxpayer's loss of the use of its money deposited in escrow, allowed the deduction in the earlier year. The decisions in those two cases are therefore clearly distinguishable from the instant one.

In *Consolidated Tea Co.* v. *Bowers* (S. D. N. Y.), 19 F. (2d) 382, the question was whether a judgment rendered against the Tea Company in 1919, appealed and paid on affirmance in 1921, was deductible in 1919. The Tea Company kept its books and filed its return on the accrual basis and set up on its books a reserve for the judgment in 1919. The question whether the deduction might be taken for the year in which the claim arose was not involved in that case, but it was held that the deduction should not be allowed for 1919 the court saying (p. 384):

> From a tax income standpoint, both logical and practical, reasons seem to me to support the conclusion that a loss should be deductible, not in the year when the judgment was rendered, but in the year when the claim was adjudicated to be final and definite, or possibly, under certain circumstances, in the year when the claim originated.
>
> In its appeal from the judgment, the tea company was denying that the claim against it was valid and that the judgment was anything more than a step toward the final determination of the claim, and that the company itself did not regard the claim as a fixed definite obligation until the judgment was affirmed by the appellate court.

A further application of the principle that an expense can not be accrued until the liability has become fixed and determined was made in *S. Naitove & Co.* v. *Commissioner* (D. C. App.), 32 F.

(2d) 949; certiorari denied October 21, 1929. In that case an agreement had been made between a company and certain of its employees under which the employees were to share in the profits of the company earned in the taxable year, on condition that the sums to which the employees became entitled should remain at the risk of the business for five years and that the discharge or withdrawal of an employee from the company during that period should terminate his right to any sum credited to him. The taxpayer company was on the accrual basis and sought to take deductions in the first year for the amounts which had been set up on the books as due to the employees. The deduction was denied on the ground that the events which were to determine and fix the company's liability to its employees could not occur until the expiration of the five years.

See also *Kaufmann Department Stores, Inc.*, 11 B. T. A. 949, (C. C. A. 3d) 34 F (2d) 257.

The essence of the principle applicable to all of these cases is that, while a taxpayer on the accrual basis may accrue a liability before it is actually paid, the taxpayer is not authorized to accrue a liability which is contingent upon the happening of events subsequent to the taxable year involved. Unless all the events have occurred which determine the liability of the taxpayer, there can be no accrual.

The theory of accrual as applied to a liability is identical with the theory as applied to income. The fact that a taxpayer keeps its books on an accrual basis does not compel it to pay taxes on contingent income or bookkeeping entries. The Treasury Department has ruled that where an item is in dispute and there is no assurance that it will be paid, it should not be reported as income until there is an adjudication that it is due, or a settlement of the dispute. Sol. Op. 41, C. B. 3–364; O. D. 642, C. B. 3–231; I. T. 1471, C. B. I–2, 67. Accordingly, if the employee in the instant case had kept his accounts on the accrual basis, he would not have been chargeable with the receipt of the amount of the judgment until it became fixed and determined by the decision of the court of last resort.

The liability of the taxpayer in the instant case is no more definite than the contingent income to the employee, and the practice of the Department deals with it in a consistent manner. A. R. R. 915, C. B. I–2, 44; O. D. 879, O. D. 917, C. B. 4, 142; Regulations 45, Article 111. This article is derived from and analogous to Treasury Decision 2433, which was approved by this Court in *United States* v. *Anderson, supra.* In principle it has been consistently followed by the Treasury. See Regulations 62, Article 111; Regulations 65, Article 112; Regulations 69, Article 112.

In the instant case the Circuit Court of Appeals, though seeking to reconcile its decision with the

decision of this Court in *United States* v. *Anderson, supra,* has, we submit, departed from the principles announced in that case.

The Circuit Court of Appeals says (R. 16–17):

> Although the amount of the damages was determined later, all the facts which *gave rise* to the liability occurred in 1919. (Italics ours.)

The thought is repeated (R. 18) where the court says:

> We think the principle of the Anderson decision covers liability for breach of contract no less than liability for unassessed taxes. In either case all the facts which *create* the liability have occurred before the end of the year. (Italics ours.)

This is the foundation upon which the court below rested its conclusion that the liability was correctly accrued in 1919, and we submit that it is erroneous. This Court in the *Anderson case* did not predicate its decision upon the occurrence of the facts which *create* or *gave rise* to the liability. The *Anderson* decision rested on the proposition that all the events had occurred which *fixed the amount* and *determined the liability.* Of course it is true that the breach of the contract in the instant case was the fact which subsequently was determined to have created the liability, but the question

whether there had been a breach of the contract and by whom it was broken were the very points at issue in the litigation which ensued between the parties.

Neither party to that litigation was in a position in 1919 to say what effect it would have upon its financial position. The respondent had the full use during 1919 of the amount of the judgment subsequently awarded against it, and any reflection of the transaction in the respondent's accounts in 1919 was based upon a pure contingency. In reality it was insurance against the happening of an event which it was hoped or expected would never happen.

The fact that respondent at the close of the year 1919 set up on its books a reserve for the breach of the contract is not sufficient to permit the accrual of the liability in that year. In *Malleable Iron Range Co.* v. *United States,* and *Consolidated Tea Co.* v. *Bowers, supra,* the fact that a reserve had been set up was not regarded as controlling. The Circuit Court of Appeals in this case seems to have given great weight to this reserve. The opinion (R. 16) sets out Article 111 of Regulations 45 which includes the following:

> A person making returns on an accrual basis has the right to deduct all authorized allowances, whether paid in cash or set up as a liability.

Construing this regulation, the Circuit Court of Appeals says (R. 17):

> Under the regulations above quoted, a taxpayer making returns on the accrual basis is required to deduct all authorized allowances "whether paid in cash or set up as a liability."

The Circuit Court of Appeals has, we submit, overlooked the fact that it is only an *authorized* allowance which can be set up as a liability. The act of setting up a liability does not conclusively determine the existence of the liability. It is only when all the events have occurred which determine the liability that an allowance for the liability is authorized. In 1919 both the liability and the amount thereof were entirely contingent and we submit that the reserve was unauthorized and in no way affects the question whether respondent may properly deduct from 1919 income the amount of a judgment subsequently awarded against it.

Article 111 of Regulations 45 further provides as follows:

> Any amount paid pursuant to a judgment or otherwise on account of damages for personal injuries, patent infringement or otherwise, is deductible from gross income when the claim is put in judgment or paid.

The earlier statement in the regulations permitting a taxpayer on the accrual basis to deduct all

"authorized allowances," whether paid in cash or set up as a liability, is not, as the Circuit Court of Appeals apparently supposed, an exception to the rule that the amount of a judgment is deductible when the claim is put in judgment or paid. Rather, the provision with respect to the "authorized allowances" of the taxpayer on the accrual basis is limited by the provision that the amount of a judgment is deductible when the claim is put in judgment. When the final judgment is *rendered* it becomes an authorized allowance to the taxpayer on the *accrual* basis in the same way that the *payment* of the final judgment becomes an authorized allowance to the taxpayer on a *cash* basis. In other words, the regulation does not purport to permit a taxpayer on the accrual basis to secure an authorized allowance merely by setting up a liability on its books. The Department has construed the regulations as requiring that the reserve must represent an actual, not a contingent liability.

See *Appeal of Greenville Coal Co.*, 3 B. T. A. 1323, 1327; *Appeal of Richmond Light and Railroad Co.*, 4 B. T. A. 91, 93.

The income tax laws do not depend for their administration upon whether a corporation in the exercise of ordinary business prudence treats an item as an asset or as a liability. This is illustrated by the opinion of this Court in *Weiss* v. *Weiner*, 279 U. S. 333, where it was said (p. 335):

> The income tax laws do not profess to embody perfect economic theory. They ignore some things that either a theorist or a business man would take into account in determining the pecuniary condition of the taxpayer. They do not charge for appreciation of property or allow a loss from a fall in market value unless realized in money by a sale. *United States* v. *S. S. White Dental Co.*, 274 U. S. 398, 401. A stockholder does not pay for accumulated profits of his corporation unless he receives a dividend. That is the general principle upon which these laws go. It is true that they allow for obsolescence of buildings, &c., where the loss is of materials, not of money; but there as elsewhere the loss must be actual and present, not merely contemplated as more or less sure to occur in the future.

In the instant case there was neither an actual loss nor an actual liability in 1919 and to permit respondent to cut down its taxable income by the amount of a judgment rendered in subsequent years is a clear distortion of 1919 income.

Even if it were true that the setting up of this reserve entitled the respondent to a deduction, it is clear that the amount allowed by the court below is too large. The reserve set up for 1919 was $14,764.79 (R. 8), but the Circuit Court of Appeals has allowed the amount of the judgment, $21,019.19 (R. 8), as a deduction for 1919. If the deduction must be allowed because of the reserve it should be

limited to the amount of the reserve and the increase in the reserve in 1920 could have no bearing upon the deduction for 1919.

The Circuit Court of Appeals held that the actual amount of damages, though determined in a subsequent year, related back to the year when the contract was broken because of the principle of contract law "that damages are suffered when the contract is broken, and are assessed as of that time, their amount being the value of the contract to the plaintiff at the time of the breach." (R. 17.)

The rule relied upon by the Circuit Court of Appeals is merely a rule of necessity which is resorted to where there is need of coming to some conclusion in regard to the damages which a party has sustained by reason of the breach of a contract. *Dunbar* v. *Dunbar,* 190 U. S. 340, 346. In that case it was held that the rule was not applicable to cases arising under the Bankruptcy Act because (p. 350):

> We do not think that by the use of the language in section 63*a* it was intended to permit proof of contingent debts or liabilities or demands the valuation or estimation of which it was substantially impossible to prove.

For the same reason we submit that the rule is wholly inapplicable here. This Court has already said in *Seattle* v. *Kelleher,* 195 U. S. 351, 359, that: "The principles of taxation are not those of contract." The Revenue Act permits a deduction for

"losses sustained," and we think it is clear that it excludes losses which are only contingent.

It is submitted that the instant case establishes a rule in conflict with other decisions in allowing an accrual, as an expense, of a sum whose amount and very existence were, at the time the deduction was sought, wholly indefinite and speculative. It also conflicts with the interpretation consistently placed upon the statute by the Treasury Department.

The position of the Commissioner in the instant case is directly supported by Article 111 of Regulations 45, *supra*. The later regulations embody the same principle and these consistent rulings are supported by the decisions cited.

To follow the decision in this case would be to unsettle or overturn all of these regulations and would result in the allowance of deductions and the inclusion of profits which were utterly contingent and which in all likelihood could not be definitely determined for a considerable number of years. To illustrate the effect of the principle of the decision of the Circuit Court of Appeals, respondent's discharged employee, keeping his books on an accrual basis, would have had to report as income for tax purposes the amounts which he would have made had he continued in the employ of respondent during the years 1919, 1920, and 1921. Revision of early returns upon a final determination would be necessary in every case of this sort, with the probability

that in many of them the statute of limitations would have run. The inconveniences which would result from such a method are obvious and are not required by the language of the statute.

CONCLUSION

It is submitted that the decision of the Circuit Court of Appeals is inconsistent with applicable decisions of this Court and in conflict with decisions of other courts; that it is contrary to settled departmental practice in the administration of the tax law; and that it should be reversed.

Respectfully submitted.

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